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Foreign branch exemption (CTA 2009 Pt 2 Ch 3A):
acceptable tax competition/simplification or ‘the heist of
the century’?

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1 Introductory remarks.

From 19th July 2011 it became possible for UK resident companies to elect for profits of their foreign permanent establishments ('PEs') to be excluded from the UK taxable base. Before the consultation period for the proposed changes had closed, George Monbiot, the well-known environmental and political activist, published an article on the proposals under the following headline¹:

'To us, it's an obscure shift of tax law. To the City, it's the heist of the century.'

The aims of this paper are twofold. Firstly, I shall attempt to determine whether the changes introduced by s48 and Sch 13 Finance Act 2011 constitute acceptable tax competition and/or simplification. Secondly, I shall consider whether Mr Monbiot was right in describing the change in tax law as a 'heist'. The metaphorical robbery concerned is the transfer of wealth from the poor and middle to the rich. According to Monbiot, the elective exemption for the profits of foreign PEs constitutes the greatest such transfer in the UK for a century. One should observe at the outset that it is possible for both of the questions posed in the objectives to be answered in the affirmative: a simpler and more competitive UK tax regime may, *prima facie*, result in a transference of wealth. However, the second-order effect on this equation of the benefits of attracting foreign direct investment is difficult to assess. In this sense, the title to the paper is somewhat misleading: the propositions are not alternatives. Furthermore, as regards the concept of acceptable tax competition, it must be acknowledged that acceptability is subjective.

In Part 2, I shall begin with a description of the problem of double taxation and the different methods of providing relief from it. The UK's decision to allow companies to opt for one of those methods in respect of the profits of their foreign branches is an apparent cause of the regressive redistribution of which Monbiot disapproves. I shall therefore consider the mechanism by which double tax relief could in theory lead to this transference of wealth. In describing the ways in which states may allow taxpayers double tax relief, I shall examine the differences between relief by credit and relief by exemption. The different approaches lead to Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN), respectively. These concepts will be analysed as general background to the FA 2011 change, in particular as to why either (or both) may be attained and be economically desirable. More UK-specific reasons for the different approach will then be reviewed, including the impact of the developing jurisprudence of the Court of Justice of the European Union (CJEU). In this context I shall argue that whether or not the foreign branch exemption was truly considered desirable for 'UK Plc', in reality the Government had little choice.

In the third part, I shall describe the operation of the new regime. Critical questions to be addressed will involve discussion of the parameters of the exemption and, in particular, difficulties in establishing the quantum of foreign branch profits (and losses) to be exempted from UK taxation. The attribution of profits to PEs is, of course, a very substantial topic in its own right. It is beyond the scope of this paper to provide a detailed exegesis on profit attribution but some analysis is required of specific problems. In

¹ <http://www.guardian.co.uk/commentisfree/2011/feb/07/tax-city-heist-of-century>

particular, as HMRC stated in its impact notes on the 2011 Budget², the exemption is likely to be of particular relevance to large financial service companies. The reasons for this will be discussed but the attribution of profits to branches in that sector gives rise to specific problems of capital attribution for the purposes of calculating deductible interest expense. Clearly, taxpayer companies that make the election will have an interest in maximising the profits attributed to their foreign PEs: this will minimise profits taxable in the UK. In that regard, companies will seek to minimise funding deductions attributable to their PEs. Similarly, tax relief for capital expenditure (capital allowances) will have to be considered since that might otherwise enable foreign branch profits to be overstated. The position as regards gains on the disposal of capital assets will also be discussed.

George Monbiot states that ‘while big business will be exempt from tax on its foreign branch earnings, it will, amazingly, still be able to claim the expense of funding its foreign branches against tax it pays in the UK.’ I shall argue that Mr Monbiot has misunderstood the situation as regards branch profit attribution, especially in light of the new Article 7 of the OECD Model Treaty.

Aside from profit attribution, other issues to be considered in respect of the exemption will be the position for electing companies whose foreign PEs have been loss-making in prior periods. Under the existing/former residence basis of taxation, those losses will have been relieved against UK taxable income of the company. Issues of the symmetrical treatment of profits and losses arise when the loss-making PE moves into profit; conversely, exempt foreign branch losses sustained in a ‘start-up’ situation might never be utilised if the relevant activities do not come to fruition.

Finally, in part 3, I shall move to a discussion of whether the complexities inherent in the branch exemption could possibly constitute tax simplification. Simplification is, of course, a relative concept so a comparison with the credit regime will be required. I shall argue that since many of the same difficulties and calculations are present under both systems, it is difficult to maintain that the FA 2011 rules simplified UK tax law in any way.

In part 4, I shall discuss tax competition. HM Treasury stated³: ‘The Government’s aim is to create the most competitive corporate tax system in the G20’. I shall begin by discussing why it was considered that a move towards fiscal territoriality via a foreign branch exemption would make the UK a more attractive location for companies operating internationally. Underlying Monbiot’s argument is the premise that the elective exemption for foreign branch profits facilitates unacceptable tax competition or, possibly, that no form of tax competition is ever acceptable. His ‘heist’ arises not just as a direct result of an export of tax base but also from corporate restructuring designed to maximise the benefit of that export. The factors of production will be moved into low tax jurisdictions with catastrophic effects for the origin country. In addition to the impact on the UK, the new rules, he says, ‘threaten to degrade the tax base everywhere’. The degradation would arise as a result of states’ being compelled continually to reduce their corporate tax rates

² Accessed at: www.hmrc.gov.uk/budget2011/overview.pdf

³ July 2010 Discussion Document p5.

so as to attract foreign direct investment: in an exemption world, the only tax payable is the tax levied by the source state.

The UK position will be considered in the context of the work of the OECD and EU on tax competition. The FA 2011 provisions' 'anti-diversion' rules will be considered in this context which, in turn, will necessitate some further discussion of the UK's new CFC rules. Artificiality and contrivance are key concepts.

Ultimately, the issues of free movement of capital in a free global market and fiscal sovereignty are at the heart of the tax competition debate. The discretionary power to raise taxes in an amount and manner of the state's choosing is one of the key attributes of nationhood. International tax law does impose constraints: no double taxation but not less than single taxation is normative. Within the constraints imposed, tax competition is regarded as being acceptable.

Finally, in light of the foregoing, I shall endeavour to draw some conclusions on the 2011 changes as acceptable tax competition and simplification and also on the 'heist' question. Despite its polemical nature, Monbiot's article raises important questions deserving of proper analysis, not least his concerns as to the nature of the tax policy-making that lead to the exemption which I find to be without foundation.

2 Double Taxation.

Juridical double taxation arises from two states imposing tax on the same legal person in respect of the same item (e.g. income, gain, asset). In the introduction to the OECD Model Tax Convention on Income and Capital⁴, it is described thus:

‘International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.’

Economic double taxation is to be distinguished in that it consists in different taxpayers being subject to taxation on the same item. An example of economic double taxation may be seen in the taxation of corporate profits: these may be taxed both on the company and on its shareholders. The taxpayer election at Chapter 3A of CTA 2009 has the primary purpose of relieving juridical double taxation of the profits of foreign establishments of UK resident companies. Such double taxation arises as a result of the UK and the other state both retaining jurisdiction to tax the profits of the non-UK PE: in international tax law the UK has the right to tax the worldwide income of the company based on the ‘in personam’ connecting factor of residence; the PE host state has fiscal jurisdiction over the company since the branch is an ‘in rem’ connection between it and the taxpayer.

2 (i) Credit and exemption.

It is generally accepted that the economic cost of juridical double taxation is an insurmountable obstacle to cross-border trade and investment. Since such activity is considered to be universally desirable (at least from the perspective of globalisation), states have sought to eliminate double taxation both unilaterally and bilaterally, via their network of tax treaties.

The methods adopted have been credit and exemption (or a combination of the two). Both techniques are acceptable as international tax norms: Article 23 of the OECD Model encompasses both approaches as alternatives. Article 23A (exemption) obliges the residence state to exempt from taxation income and capital that may, in accordance with the treaty, be taxed in the source state⁵. The exemption is to apply irrespective of whether the source state actually taxes the income or not. Article 23B (credit) obliges the residence state to deduct tax paid in the source state from the domestic tax liability. Under credit systems, the reduction for foreign tax is invariably limited to the domestic tax payable on the relevant income: the so-called ‘ordinary credit’ limitation. (The ‘relevant income’ may refer to the particular source or country or group of countries.) Credit and exemption are also acceptable alternatives under the EU Parent-Subsidiary Directive⁶. Blanluet and Durand⁷ commented that International Fiscal Association branch reports revealed a fairly even distribution of credit and exemption methods among the domestic tax laws of IFA reporting countries: 11 states were pure credit jurisdictions and 8 states used exemption. 13 countries used a hybrid

⁴ OECD Model Tax Convention on Income and Capital 2010, hereinafter ‘OECD Model’.

⁵ Article 23A (exemption method) provides for the credit method to apply in respect of tax withheld on dividends and interest in the source state.

⁶ Council Directive of 23 July 1990 (90/435/EEC).

⁷ IFA 2011, volume 96b.

system, applying credit relief in general but exempting the profits of foreign subsidiaries. (Two states had no domestic provisions for double tax relief.)

Credit and exemption have been closely aligned with two models for achieving tax neutrality. Received economic wisdom is that tax neutrality (whereby tax is not a distortive factor in business and investment decisions) leads to an optimal allocation of resources. The respective models are Capital Export Neutrality ('CEN') and Capital Import Neutrality ('CIN'). Blanluet and Durand⁸ rightly remark that differences between the two neutralities 'have resulted in endless and spurious controversies, as shown by an overly abundant literature discussing the comparable merits of each proposed system.' They may also be valid in stating that these questions (and credit versus exemption discussions) pertain more to politics and economics than they do to taxation. A brief analysis is, nevertheless, required since, as will be described in the following section, the FA 2011 provisions may be seen as part of a general UK shift in the direction of CIN/exemption.

In summary, CEN is accomplished when taxpayers are subject to an equivalent level of taxation whether they invest at home or abroad and this is achieved by the residence state taxing the worldwide income of its residents. Thus residents do not have a financial incentive to invest in low tax jurisdictions and there is 'horizontal equity' between those taxpayers who invest domestically and those who invest internationally. There would, however, be a disincentive to invest in other states if no relief were given for source state taxation so credit relief is required for true neutrality to obtain. (Under an 'ordinary' credit system, as discussed above, relief is limited to domestic tax payable on the income concerned. If, therefore, the source state imposes a higher level of taxation than the residence state, CEN will not occur: the investor would have a higher effective rate of taxation as a result of investing in the other country.)

Under CIN, by contrast, all investments into a particular state have to bear the same effective tax burden; when that applies, residents and non-residents can compete on equivalent terms in the given market. This requires the assignment of taxing rights solely to the source state and, therefore, exemption from tax in the state of residence of the capital exporter. In the following section I shall discuss why it might be that the UK has apparently decided to move from CEN (credit) to CIN (exemption).

Firstly, however, it is necessary to discuss how 'an obscure shift of tax law' (a limited change in the method of relieving double taxation) could generate the transference of wealth that is Mr. Monbiot's 'heist'.

The mechanism that could give rise to regressive redistribution is that the corporate tax yield would decrease as a result of exempting from charge the profits of UK companies' foreign PEs. Absent a reduction in public expenditure and/or an increased public sector borrowing requirement, the lost revenue would have to be collected by an increase in other taxes such as VAT. Reducing taxation on the return of capital invested in companies whilst increasing that levied on consumption reduces the ratio of tax paid to income for the wealthy but increases it for the poor. Hence the measure could be regarded as being regressive.

The global effects of shifts in the tax 'mix' are uncertain. From the UK perspective, however, the immediate question is whether a change from credit to exemption for a particular type of

⁸ *ibid*

outbound investment would necessarily result in a reduction in corporate tax revenue. Under the credit system, *ceteris paribus*, the profits of foreign branches generate revenue for the UK Exchequer only to the extent that they have been subject to a lower level of taxation in the host country. Effectively, additional tax is paid in the UK to ‘top-up’ the host state tax to secure that the effective rate of tax on the relevant income is that of the UK (hence CEN would be achieved). Therefore, any diminution in UK Corporation Tax collected as a result of the move to exemption could only arise as the difference between the UK effective rate and the host country rate on profits attributable to the PE.

According to HMRC’s Tax Information and Impact Note published on March 23rd 2011⁹ the Exchequer impact of the (then) Budget proposal to offer foreign branch exemption was as follows (£m):

<u>2011-12</u>	<u>2012-13</u>	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>
0	-30	-70	-80	-80

The financial impact will take into account the negative effect described above but also the positive effect of excluding overseas branch losses (as described in Part 3, below). Based on the total tax collected by HMRC (£467bn in 2011-12) it is clear that the expected impact of the exemption is nugatory in the extreme. Even as a proportion of the total Corporation Tax collected, the expected cost is less than one fifth of one percent¹⁰. The clear conclusion is that if the change is, in any sense, a ‘heist’ (which seems unlikely given the projected effect), it certainly cannot be described as ‘the heist of the century’.

This is not to say that the FA 2011 changes might not, indirectly, have harmful global effects but these aspects are discussed further in Part 4, below. One should also note in passing that the further cuts in the statutory rate of Corporation Tax announced in the 2011 Budget are expected to have a far more significant direct impact on the Exchequer. The revenue effects (in addition to those of the reductions in FA 2010) were projected as follows (£m):

<u>2011-12</u>	<u>2012-13</u>	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>
-425	-810	-910	-1,000	-1,075

2 (ii) UK background.

From 1945 to 2009 the UK gave relief for double taxation by way of (ordinary) credit. This is a reflection of significant domestic demand for capital. In broad terms, where capital is required to fund the growth of domestic industries, it is rational not to offer fiscal incentives to invest abroad (e.g. by exempting low-tax foreign profits).

In 1999 the (then) Inland Revenue concluded its analysis of technical arguments on credit and exemption by stating ‘...it would seem desirable for the United Kingdom to retain the credit

⁹ Accessed at: <http://www.hmrc.gov.uk/budget2011/tiin6420.pdf>.

¹⁰ Applying the cost of the measure to the long-term average Corporation Tax contribution for 2011-12 receipts. See further below at 4 (iii).

method of DTR and not to adopt the exemption method.’¹¹ The main arguments in favour of retaining credit were that exemption encourages the diversion of resources into low tax jurisdictions and would not, in any event, simplify tax compliance. In the same document it was also stated that ‘the United Kingdom should not consciously engage in competing with other countries over which has the more generous DTR system’¹². The FA 2011 changes suggest that this was reconsidered.

In 2007, however, HMRC and HM Treasury announced that they would be consulting on foreign dividend exemption and the Controlled Foreign Companies (‘CFC’) regime for taxing undistributed profits of subsidiaries in low tax jurisdictions. That consultation led to an effective dividend exemption from 1st July 2009 onwards and, thence, to the FA 2011 branch exemption election. Among the government’s stated aims in exempting PE profits was the alignment of the treatment of foreign branches and subsidiaries. The genesis of the dividend exemption is, therefore, intrinsic to the move to branch profits exemption so it is necessary to consider the developments between 1999 and 2007 that led to the former change.

The agents of change during this period were European Community Law and declining UK competitiveness resulting in a series of corporate inversions¹³ by large multinational companies headquartered in the UK.

Regarding the former aspect, in late 2006 the European Court of Justice (‘ECJ’) delivered its judgement in the FII Group Litigation case¹⁴. Under the system in force at the time¹⁵ and for many years previously, UK companies were exempt from Corporation Tax on dividends and distributions of other UK resident companies¹⁶. Dividends received from non-UK companies were, however, taxable. Credit was given for any withholding tax on the dividend received and, subject to a minimum 10% ownership test, foreign tax paid in the corporate profits underlying the dividend.

In the FII case, the claimants argued, inter alia, that the difference in treatment between dividends from UK and non-UK companies was a restriction on their freedom of establishment under (then) Article 43 TEC and an infringement of the guaranteed free movement of capital under Article 56 TEC.

The ECJ held that where credit for underlying tax was available (i.e. >10% ownership), the differing treatment in the UK did not breach the TEC ‘provided that the rate of tax applied to foreign-sourced dividends is no higher than the rate of tax applied to nationally-sourced dividends’. Where no credit for underlying tax was available, the Court held that the UK distinction did breach Article 56. (Free movement of capital was the applicable freedom, rather

¹¹ IR 1999 Discussion Document p19.

¹² *ibid* p7.

¹³ ‘Inversions’ broadly consist in transferring the fiscal jurisdiction of the group holding company. This is effected by incorporating a new company in a suitable jurisdiction and offering shares in that new vehicle to shareholders in exchange for their existing holdings. The subsidiaries are then sold or distributed in specie to the new holding company.

¹⁴ Test claimants in the FII Group Litigation v Commissioners of Inland Revenue. 12th December 2006, Case C-446/04.

¹⁵ s208 Income and Corporation Taxes Act 1988 (‘ICTA’).

¹⁶ Dividends etc received on shares held as trading assets were taxable.

than freedom of establishment since portfolio holdings would not give the owners the required ‘definite influence’ over the company’s affairs.¹⁷⁾

The ECJ left the question of differing rates of tax to the domestic court to decide. HMRC and HM Treasury, however, did not wait for the judgement of the High Court. Whether acting to stem the rising tide of corporate inversions or (rightly) unconvinced that credit for underlying tax could arguably give equal treatment to UK and non-UK dividends, they began consulting on exemption in 2007 as discussed above.

The High Court delivered its judgement on the tax rate question in November 2008¹⁸. Henderson J held UK and non UK dividends had to be based at the same effective rate. By then, however, it had already been announced (in the Pre-Budget Report) that dividends from non UK companies would, generally, be exempt.

As Professor Avery Jones pointed out in his 2011 Klaus Vogel lecture¹⁹, it would be surprising if different treatment for dividends and PE profits viz. double tax relief was sustainable: ‘the taxpayer is effectively given a choice of system depending on how the investment is structured.’ The alignment of branches with subsidiaries in FA 2011 may also be seen as pre-emptive of a potential incompatibility with European Union law. Articles 49 and 54 TFEU have the effect of prohibiting restrictions on companies from setting up branches or subsidiaries in other Member States. A different (inferior) treatment as regards double tax relief for branches from that of subsidiaries could constitute a restriction imposed by the home state on its residents’ freedom to establish themselves in the other Member State. Therefore, pace Mr Monbiot, we may conclude that due to its treaty commitments to its EU partners, the UK had no option but to a) exempt dividends from non UK companies from tax and b) (therefore) exempt the profits of foreign branches also.

¹⁷ A line of earlier cases had determined that ‘definite influence’ was a necessary condition for the freedom of establishment to be engaged.

¹⁸ Test claimants in the FII Group Litigation v HM Revenue & Customs [2008] EWHC 2893.

¹⁹ Avery-Jones 2011, paragraph 9.

3 The foreign profits exemption in practice.

In the following section I shall consider the detailed application of the exemption, including the mechanics of the election and specific problems such as losses, capital allowances and capital gains. First, however, it will be necessary briefly to consider the definition of the business vehicle, the profits of which may be the subject of the exemption election. Central to the operation of the new regime is the quantification of the profits to be exempted: I shall consider this critical issue in the context of international tax law and recent developments in this area. The issue of the expense of funding foreign branches where the profits are exempt was central to the Monbiot critique of the new regime so that aspect will also be addressed.

3 (i) Mechanics of the election and considerations for companies.

A company may elect for the profits and losses of its foreign branches to be left out of account for UK tax purposes. The election is in respect of all foreign PEs of the company (although see below in respect of the loss-streaming provisions). It applies to the first accounting period of the company beginning after the date of the election and is irrevocable, although may be withdrawn prior to the start of the first accounting period after the election. The reason for the election being irrevocable is that it would otherwise be possible for companies to opt in and out depending upon results; opting for exemption when, broadly, the foreign branches are profitable but including any losses in the UK tax base in unprofitable years. Clearly, companies will have to consider the position very carefully, in aggregate. That analysis contains many variables some of which are discussed in the sections following.

The election works so as to require ‘exemption adjustments’²⁰ to be made to ensure that the ‘foreign permanent establishment amount’²¹ is not taken into account in calculating a company’s taxable profits for the accounting period. This amount is the aggregate of all the profits net of losses per territory for all the territories ‘outside the United Kingdom in which the company carries on, or has carried on, business through a permanent establishment.’²²

A ‘permanent establishment’ of a company for these purposes is:

‘....a fixed place of business [...] through which the business of the company is wholly or partly carried on or an agent acting on behalf of the company [that] has and habitually exercises [...] authority to do business on behalf of the company.’²³

Examples of ‘fixed places of business’ are then given in the statute, followed by an exclusion from agency PE classification for, broadly, agents of independent status. Also excluded are fixed places of business wherein the only activities undertaken are ‘of a preparatory or auxiliary character.’²⁴

This definition of PE is almost identical to that at Article 5 of the 2010 OECD Model Treaty. There are minor differences such as the inclusion in the UK statute of ‘an installation or structure for the exploration of natural resources’. Furthermore, under the UK legislation, there is no requirement for a building site to last for more than 12 months to constitute a PE.

²⁰ s18A(2) CTA 2009.

²¹ s18A(4) *ibid.*

²² s18A(5) *ibid.*

²³ s1141(1) CTA 2010.

²⁴ s1143(2) *ibid.*

The significance of these differences should not be overstated but it is at least theoretically possible that a PE may exist for purposes of the foreign branch exemption but not under the applicable double tax treaty (if congruent with the OECD Model).

3 (ii) Profit attribution.

Once it has been determined that a PE exists in a territory, it is necessary to attribute profits of the company to that PE in order to quantify the tax-exempt amount for the UK company. Under established attribution principles it is possible for a branch to be profitable when the organisation itself is not, and vice versa. Within an exemption regime, these results can have the effect of increasing UK losses or profits, respectively. Two approaches to attribution are prescribed, depending on the tax treaty status of the host state of the PE. (One may observe at this juncture that differing requirements for different branches may call into question any simplification claim for the new rules.)

Where, firstly, the foreign PE of the UK company is located in a ‘full treaty territory’²⁵, the profits to be the subject of the exemption are quantified in the same manner as for establishing the limit on credit for foreign taxes for companies that do not make the exemption election. The relevant legislation is to be found at s43 of the Taxation (International and Other Provisions) Act 2010 (‘TIOPA’) which was introduced by paragraph 27 of Schedule 13 to FA 2011.

Alternatively, where the electing UK company operates via a branch in a non-treaty (or non-full treaty) territory, exempt profits are calculated by an attribution based on the OECD Model.

Regarding PEs in full treaty territories, the question arises as to whether the quantification of exempt profits under the credit limitation methodology would have the same result as that under the applicable treaty. Similarly, under the alternative methodology, where there exists a double tax treaty between the UK and the host state (that does not contain a non-discrimination article), could there be differences between profit attribution under that treaty and the OECD Model?

Differences in profit attribution under an exemption model can lead to double (or less than single) taxation as may be illustrated by the following example:

Gamma, resident in State C, has a PE in State D.
Global profits in the year to 31 December XY are 20,000,000
State D attributes profits of 5,000,000 to the PE and taxes these profits at a rate of 30%.
State C attributes profits of 4,000,000 to the PE for exemption purposes.

State C taxes the global profits at 30%	6,000,000
Less tax attributable to exempt foreign profits (=4,000,000 @ 30%)	<u>(1,200,000)</u>
State C tax due	4,800,000
State D tax due	<u>1,500,000</u>

²⁵ ‘Full treaty territory’ is defined (at s18R CTA 2009) as being a jurisdiction with which the UK has concluded a double tax treaty containing a non-discrimination provision. A ‘non-discrimination provision’ is a rule whereby permanent establishments of the treaty partner in the other state are not to be taxed less favourably than resident enterprises of that other state.

Total tax liability 6,300,000

Thus profits totalling 1m have been taxed both in the host state and in the residence state. If, conversely, C had attributed profits of 6m to the exempt foreign branch, profits of 1m would have escaped tax.

The credit limitation method at s43 requires profits to be attributed to PEs as if they are 'distinct and separate' enterprises that:

- (a) engage in the same or similar activities under the same or similar conditions and
- (b) deal wholly independently with the (other parts of) the company.

This methodology is an application of the 'authorised OECD approach' to profit attribution that was developed over a series of discussion drafts from 2001 onwards, leading to the 2010 Report on the Attribution of Profits to Permanent Establishments. As part of this process, the 2008 Discussion Draft²⁶ prompted a revision to Article 7 of the Model Treaty and Commentary.

The issues associated with this approach (rather than the alternative of formulary apportionment of the entity's results) are manifold and largely beyond the scope of this study. The principal problem, however, is that the separate enterprise method is founded on a fiction. As Baker and Collier pointed out in their General Report to the 2006 IFA Congress on the subject:

'....a PE is not a separate legal person. Thus, in legal terms:

- there can be no legally binding contracts between a PE and other parts of the enterprise;
- there can be no separate ownership of assets by the PE or its head office;
- no payments can be made between the PE and its head office since the funds paid belong in law at all times to the same person; and
- strictly speaking, no profit can be realised on a dealing between a PE and its head office.'

There is also an inherent inconsistency in the Article 7 requirement that the putative separate enterprise must be engaged in the 'same or similar activities under the same or similar conditions' (as the PE); that must necessitate some recognition of the fact that the branch is part of a larger organisation. Thus a situation arises whereby a PE is separate and distinct and yet has attributes of the enterprise of which it is a part that it would not have if it were, indeed, a separate entity (e.g. credit rating).

The UK credit limitation rules that establish the quantum of exempt profits were amended at the same time as the election for exemption was introduced. The changes are relevant to an analysis of the question above regarding potential differences in attribution between s43 and an applicable double tax treaty.

²⁶ Discussion Draft on the Attribution of Profits to Permanent Establishments, OECD 2008.

Prior to FA 2011, the profits attributable to overseas PEs for credit relief purposes were determined by reference to the rules²⁷ for attributing profits to UK PEs of non-residents. Those rules were to be applied ‘with the necessary modifications’. The new regime is, *prima facie*, almost identical to the former. For example, the separate enterprise principle is, *mutatis mutandis*, described in precisely the same terms at s43(2)(a) and (b) TIOPA 2010 as it is at s21(1)(a) and (b) CTA 2009. There is also the same presumption that the putative separate company has the same credit rating as the organisation itself. There are, however, subtle differences between the approaches to UK and non-UK PEs, relating specifically to capital attribution.

The attribution of capital to PEs is critical in determining the quantum of profits. In summary, equity capital is ‘free’ in that the cost of the capital (dividends) will not be tax deductible. The mix of capital attributed to the branch will make a significant difference to the exemption: the higher the amount of free capital attributed to the PE, the greater the level of tax-exempt profits. We may note a potential conflict in capital attribution for domestic and foreign branches in this respect: the domestic tax base will be increased by maximising the amount of capital to be attributed to non-residents’ UK branches whilst minimising the capital attributed to UK residents’ exempt overseas branches.

Capital attribution will be particularly important for the banking industry (to which sector the exemption is expected to be most relevant). Banks’ capital adequacy ratios (effectively, the proportion of assets that must be funded out of equity) are internationally determined²⁸ but monitored and enforced at the national level. Banks are supervised by the regulators in their home country. Provided that adequate levels of capital are maintained at the enterprise level overall, banks may effectively fund their activities conducted in overseas PEs entirely by debt. Hence banks operate via a branch network to enable scarce regulatory capital to be easily deployed in generating the best return. (One should note in passing that, at the time of writing, regulatory authorities may be reconsidering branches in response to perceived failings of this system in the global financial crisis.) The (dis)incorporation of appropriately capitalised legal entities as vehicles would be a relatively cumbersome and inefficient process in comparison.

Under the new tax regime for non-UK branches, debt and equity capital of the enterprise is to be allocated to PEs on a ‘just and equitable’ basis, taking into account the entity’s capital usage in other locations as if each branch were a separate legal entity²⁹. For UK branches of non-residents, capital has to be attributed based on the amount that a separate legal entity would reasonably be expected to hold. This difference, between an allocation and the so-called thin capitalisation approach is subtle but could be important.

In its 2008 report on profit attribution, the OECD’s recommended methodology for allotting capital is, firstly, to attribute assets to the PE based on an analysis of ‘key entrepreneurial risk-taking functions’ and ‘significant people functions’. The next step is then to attribute free capital to support the risks (assets) that have been attributed. Three methods may be used to allocate equity:

²⁷ @ Pt 2, Ch 4 CTA 2009.

²⁸ E.g. in accordance with the prudential standards established by the Basel Committee on Banking Supervision – Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework (2006).

²⁹ s43(3)(b) and (4) TIOPA 2010.

- (i) capital allocation;
- (ii) thin capitalisation;
- (iii) quasi-thin capitalisation/regulatory minimum capital amount.

Under the capital allocation approach, the total of the bank's relevant equity is allocated to its permanent establishments based on their relative holding of the whole bank's risk-adjusted assets. The thin capitalisation approach effectively seeks to attribute capital based on the amount that an independent entity carrying on the same or similar activities under the same conditions would typically hold. The third alternative basis is a variant on the thin capitalisation approach whereby capital is attributed based on the minimum amount a local regulator would require of a legal entity established in that state with the same assets.

Each methodology, the OECD argues, has arguments in favour and against. The conclusion³⁰ was that, although there is consensus that capital should be allocated to PEs, 'it will not be possible to develop a single, internationally accepted approach for making that attribution of capital'.

It will be apparent that the UK legislation encompasses a capital allocation approach for overseas branches and a thin capitalisation approach for UK branches. The inconsistency may not, ultimately, be material but the difference is intriguing in that the latter approach would tend to increase the amount of free capital attributed to a branch: there is no effective limit based on the total capital of the entity itself as there is under the capital allocation methodology. Additionally, the rules for attributing profits to UK PEs do not allow deductions for royalties paid to other parts of the company in consideration for the use of intangible assets (although a deduction for a contribution to the costs incurred in creating intellectual property is allowed). Furthermore, deductions are not allowed for interest payments on intra entity funding (except, broadly, for branches of banks). Neither of these restrictions applies to the s43 TIOPA rules for attributing profits to non-UK branches for credit limitation or exemption purposes. As a result, the quantum of exempt profits is likely to decrease.

The issue, however, is whether the capital allocation approach under s43 could conflict with that under the relevant double tax treaty with the host jurisdiction. As can be seen from the above example of Gamma, double (or less than single) taxation can arise from different attributions of profit in the source and residence states. In this respect, perhaps somewhat unnecessarily given the precedence of double tax treaties over domestic UK law, s43(5) was inserted by FA 2011 to make clear that the capital attribution methodology for credit and exemption purposes is subject to the provisions of the applicable treaty.

One might add, in passing, that s43(6) was added to ensure that capital attribution for tax purposes is independent of any capital 'held' in branches according to the company's management accounts. This provision, itself subordinate to double tax treaties, was presumably included as a result of successful litigation undertaken by Nat West Bank in the United States where it operated through a branch³¹. In brief, the bank successfully argued that its US branch could deduct interest 'paid' on intra-bank funding it had received on the grounds that the (then) US/UK double tax treaty required the branch to be treated as a separate legal entity dealing with the rest of the bank at arm's length. The US domestic rules

³⁰ OECD report para 124

³¹ 44 Fed Cl 120 (1999) ('Nat West I') and 58 Fed Cl 491 (2003) ('Nat West II').

(Treasury Regulation 1.882-5) required a formulary apportionment of the entity's funding costs.) In *Nat West II*, the bank successfully argued that properly maintained accounts of the US branch should be used to determine its business profits, including funding costs, under Article 7 of the treaty; it was inappropriate to allot notional capital to the branch. The US Federal Claims Court's findings were prefigured 25 years earlier when a group of UK banks sought an opinion on the subject from leading counsel³². His opinion was that 'the Convention gives no authority to write into the branch accounts a level of capital which the branch does not have.' One should add, however, that in an Exchange of Notes on the 2001 US/UK treaty of 2001, it was made explicit that profits attributable under Article 7 are to be derived having attributed capital on a thin capitalisation basis or for financial organisations except for insurance companies, on a capital allocation basis. *Nat West Bank's* arguments would not, therefore, be successful having regard to the new treaty.

For full treaty partners, profit attribution for exemption purposes will, effectively be in accordance with the treaty (specifically as regards capital attribution) but Article 7 may be interpreted differently by the home and host state tax authorities. If double taxation results, the taxpayer may have recourse to the Mutual Agreement Procedure under the relevant treaty although the difficulties associated with such an approach may render the process deeply unsatisfactory. Where home and host states are Member States of the European Union, the provisions of the Arbitration Convention could be invoked to obviate double taxation³³.

In recognition of the difficulties associated with asymmetric profit attribution, the OECD revised Article 7 in the 2010 Model Treaty. Under new Article 7(3), where a state adjusts profits attributable to a permanent establishment and thereby taxes profits that have already been subject to tax in the other state, the other state is required to adjust its tax base 'to the extent necessary to eliminate double taxation.'

This seemingly good news should be tempered somewhat by, firstly, the observation that it may take many years for the new Article 7 to be incorporated into new bilateral treaties, as they fall to be renegotiated Secondly, the Commentary on new Article 7(3) seems significantly to limit its application: it seems that where an adjustment made by a contracting state is in accordance with a valid attribution under Article 7(2), recourse must still be had to the Mutual Agreement procedure to obviate double taxation.

Where an overseas branch is situated in a non-full treaty location, UK exempt profits are to be derived by applying the OECD Model Treaty. Possibilities for asymmetric profit attribution may arise from differences between a treaty (if there is one) and the OECD Model. Under Article 7 of the new OECD Model, deductions are permitted for interest payments by branches of non-financial enterprises and internal royalty payments. Most of the UK's existing treaties may not permit such deductions which could in theory lead to double taxation. In practice, however, it may be the case that the UK has no (full) treaty with the other state because it is in some way considered to be a tax haven: the diminution in the UK exempt amount caused by deductions for interest and royalties might not cause double taxation, simply a reduction in the amount of corporate profits escaping taxation in either jurisdiction.

³² Opinion of Michael (later Lord) Nolan QC.

³³ Convention 90/436/EEC. The Convention is not actually a part of EU law. It is a multilateral public law convention and thus does not, per se, have direct effect. It is dependent for its effect on national enactment. In the UK, the Convention is given effect and priority over domestic law and treaties by s126 and 127 TIOPA 2010.

Profit attribution is a highly complex activity and its application for the purposes of exemption will be no different. There may even be added complexity given the different permutations around the treaty status of the host state. Attribution to overseas PEs is, however, already necessary for credit relief purposes under UK domestic law and the provisions of its double tax treaties on the method of giving relief from double taxation. (Those provisions effectively require the UK to grant credit for foreign tax which the source state has the right to tax under the treaty: the business profits of UK companies may only be subject to tax in the host state if and to the extent that they are attributable to a PE there.) Whilst, therefore, the FA 2011 changes in no sense represent a simplification in this respect, the complexity (or most of it) was already present.

3 (iii) Capital allowances and capital gains.

Companies electing into the foreign branch exemption will be unable to claim UK tax allowances on capital expenditure on plant and machinery used in the PEs subject to the election. This is on the grounds that capital allowances in respect of such expenditure are given for the purposes of qualifying activities. Qualifying activities are those in respect of which profits are chargeable to UK tax³⁴. Where an election is made to exempt foreign branch profits from UK tax, then the activities of the relevant PEs will not be qualifying activities so actual capital allowances will not be available.

Notional capital allowances will, however, be given automatically on assets used for the purposes of an electing company's PEs. This will align the treatment with the pre-existing/continuing credit system: in establishing the UK tax payable on the foreign branch profits for credit limitation purposes, available capital allowances reduce the capacity to absorb foreign tax credits; notional capital allowances will reduce the amount of the UK-exempt profits under the election.

The mechanism by which the transition to exemption occurs is that existing assets will be deemed to be have been liquidated at their tax written down value³⁵ which will establish the available 'cost' to the newly-exempt branch for the purposes of calculating the future notional allowances. No claw-back or top-up of allowances previously given to the company (balancing charges and balancing allowances, respectively) will, therefore, arise.

There is, however, some complexity where the relevant assets have been used for purposes other than those of the foreign branch(es) in an earlier period. In those circumstances, market value has to be used as disposal value for the purposes of balancing adjustments and qualifying expenditure for the newly-exempt branch(es).

Where the historic cost of assets used otherwise than for foreign branch purposes is less than £5m, there is no need to deem a market value disposal. If the cost exceeds £5m but is less than £50m, the relevant earlier period within which to consider 'onshore' use extends only to accounting periods ending in the 12 months up to and including 18th July 2011 (the day before Royal Assent of FA 2011). However, if the cost exceeds £50m then it is necessary to

³⁴ s15 Capital Allowances Act 2001, inserted by FA 2011 Sch 13, para 15.

³⁵ Tax written down value = value of the asset still to be depreciated for tax purposes.

consider non-foreign branch use in accounting periods beginning in the 6 years up to 18th July 2011 to determine whether market value should be used as the 'disposal' proceeds.

The rationale of the special market rate rule for high value purchases is that very significant UK tax relief may have been claimed via capital allowances and, since the relevant assets will be excluded from the UK tax base in future, no claw back of excessive allowances (a balancing charge) would be possible if accelerated tax depreciation had been enjoyed.

The complexity inherent in the capital allowances analysis must, to a significant extent, refute the argument that the FA 2011 reforms represent tax simplification.

Gains and losses arising on capital assets of companies are, in principle, within the scope of the exemption to the extent that those assets have been 'relevant' in the calculation of the profits and losses to be excluded under the election³⁶. In effect, if the relevant double tax treaty (or OECD Model in the case of non-full treaty partners) awards taxing rights over gains arising to the host state, then any gains will be exempt in the UK.

In this regard, considering Article 13 of the OECD Model Treaty for illustrative purposes, the host state may tax gains arising on the alienation of immovable property within its territory and also those arising on moveable property 'forming part of the business property of a permanent establishment' therein³⁷.

The requirement to determine whether any specific asset forms part of the business property of a permanent establishment gives rise to particular problems. (One may observe that this aspect is another problem with the fiction of the branch as a putative separate legal entity: the legal position is simply that assets are owned by the company, not any particular part of it or location wherein it operates.)

The OECD Model Commentary on Article 13³⁸, drawing on the 2010 report on the Attribution of Profits to Permanent Establishments, uses the criterion of 'economic' ownership to determine whether assets should properly be regarded as forming part of the business property of permanent establishments. Essentially, 'economic ownership' for these purposes consists in enjoying the right to income from the asset and exposure to gains and losses arising from appreciation or depreciation of the property. Local recording of the asset in a balance sheet for management accounts purposes is insufficient to imply business property status for the branch.

Thus far we may conclude that if the foreign branch enjoys economic ownership of an asset, the host state may tax any gains arising on its disposal and, therefore, the gains will be exempt in the UK if the company has made the election under s18. Problems arise, however, when assets are transferred (in an economic ownership sense) between permanent establishments and the UK head office.

³⁶ s18B(1) CTA 2009.

³⁷ On the grounds that treaties allocate taxing rights over immovable property to the source state with no requirement for attribution to a permanent establishment, it was necessary to insert s18B(2) to bring relevant gains within the scope of 'attribution' under s18A(6). Gains and losses on immovable property are, in effect, excluded to the extent that the asset 'has been used for the purposes of the business carried on by the company through the permanent establishment in the territory (to such extent as is appropriate having regard to the extent to which it has been so used)....'

³⁸ @paragraph 27.1

Where, for example, the company disposes of an asset that had previously been transferred-in from an exempt branch, the part of the gain arising on the ultimate disposal that is attributable to the branch's period of 'ownership' is exempt. HMRC Draft Guidance on the exemption gives helpful insights into how the exempt portion of the gain might be calculated. If, for example, the host state taxed the gain on the earlier transfer of the asset to head office based on a deemed market value disposal, the amount of the gain previously taxed might be the exempt portion of the ultimate, actual, disposal. Alternatively, where no market value on the initial 'disposal' was obtained because, for example, it was not taxed by the host state, it may be possible to time-apportion the ultimate gain based on years of economic ownership by the exempt PE.

Under s18B(3) where the host state has taxed a gain on transfer in a period before the UK company elected for exemption, then the relevant piece of any subsequent gain will not be exempt; credit relief will be available for the foreign tax paid.

In addition, there are rules deeming intra-group transfers to be at market value where the transferor group company has used the relevant asset in an exempt foreign branch³⁹. Ordinarily, under group-relief provisions for Capital Gains Tax, the transfer value on an intra-group transfer would be deemed to be such as would give rise to neither a gain nor a loss for the transferor. The transferee company inherits the base cost of the transferor, to be deducted from disposal proceeds on any subsequent disposal to a third party. However, where the asset has been used in an exempt foreign branch of the transferor, the existing rules would result in the part of the gain arising during the branch's period of ownership not benefitting from the exemption on ultimate disposal. Accordingly, by applying market value to the otherwise no gain/no loss earlier transfer, the real gain realised by the transferee will be exempt to the extent of the increase in value realised during the branch's ownership period. The rules will operate in the same way for other disposals deemed to be at no gain/no loss such as where gains are reinvested into replacement business assets ('rollover relief'). In addition, in comparable circumstances, transfers of intellectual property will be deemed to be at market value rather than tax written down value, as is usually the case⁴⁰.

In respect of capital gains, one may conclude that the significant complexity outlined above is such that it is untenable to describe the foreign branch exemption as a simplification.

3 (iv) Losses.

Under the UK system of taxing resident companies on their worldwide income, any losses arising in foreign branches are immediately available to offset taxable profits from domestic and other sources. If overall losses are created as a result of the fiscal consolidation of non-UK branch results, then those losses may be surrendered to associated companies or, subject to restrictions, carried forward against profits of future accounting periods. The issue of companies carrying forward foreign branch losses against UK domestic profits without the right to tax future profits of those foreign branches was of significant concern to HMRC when the possibility of a foreign branch exemption was initially raised.

³⁹ s276A TCGA 1992, introduced by FA 2011.

⁴⁰ s775(4)(c) CTA 2009.

The credit system effectively allows ‘claw-back’ of the loss relief that has previously been given in that, assuming carry-forward of the loss in the other jurisdiction and a return to profit there, the amount of foreign tax credit reducing the UK Corporation Tax payable is, itself reduced. A straightforward example is as follows. (This assumes that the rate of tax is the same in the home and host states).

	Year 1	Year 2
UK profits	5,000	4,000
PE state profits/(losses)	(2,000)	3,000
	<u>3,000</u>	<u>7,000</u>
UK Tax @30%	900	2,100
Foreign tax credit	=	(300)
Tax payable	<u>900</u>	<u>1,800</u>

In the example, the foreign tax credit in Year 2 is restricted to the tax actually paid in the host state (= (3,000 less brought forward losses of 2,000)@30%). Thus, in Year 2, the UK is effectively taxing foreign profits of 2,000 with no corresponding double tax relief. Clearly, the possibility of ‘claw-back’ would not exist if the company opted to exempt foreign branch profits from the start of Year 2. Furthermore, if the Year 1 foreign branch loss exceeded 5,000 then, losses would continue to reduce the UK tax base after the election.

To counter this problem and a potentially significant loss to the Exchequer, the new regime applies so as to exempt foreign profits only if and to the extent that previous losses of foreign branches (= the ‘total opening negative amount’⁴¹) as at the start of the first exemption period have been exhausted by profits. The rules are complex with exceptions and sub-elections; in no sense could this aspect of the new rules be considered to be a ‘simplification’. Draft guidance notes specifically on the use of losses in the ‘transitional period’ run to 6 pages⁴².

In essence, the requirement is to consider aggregate net losses arising in all PEs, starting with the first loss-making period starting within six years of the beginning of the first exempt period. Where a loss greater than £50m was sustained in any single jurisdiction, the six-years is extended back to the six years ending on 18th July 2011⁴³. If, for example, a company elected for exemption to take effect for its 2025 accounting period, it would still have to consider the following calculation to determine whether it had an opening negative amount if any branch had suffered losses in excess of £50m. One might remark that this could be a significant administrative disincentive to elect in view of the global financial crisis affecting, most particularly, banks and financial institutions.

Losses are deemed to be carried forward and offset by the first available profits. The cumulative total of the losses is not reduced below nil when profits exceed brought forward losses. Capital gains and losses are ignored for the purposes of deriving the opening negative amount. If, at the beginning of the first exempt period, there is a negative balance derived from this calculation, then profits up to the total of that brought-forward negative balance are not covered by the exemption. Credit relief will continue to be available for foreign tax paid. The approach may best be illustrated by the following example:

⁴¹ s18J CTA 2009.

⁴² <http://www.hmrc.gov.uk/guidance/branch-exempt-draft-guid.pdf>.

⁴³ Para 34, Sch 13 FA 2011.

Mega Limited.

Accounting periods ending 31/12	P/E profits/(losses)
2010	(500)
2011	1,000
2012	(7,000)
2013	3,000
2014	2,000
2015	4,000
2016	(2,000)
2017	6,000

Mega Ltd elects for its foreign branch profits to be exempt from the start of its accounting period beginning 1st January 2015.

In 2015, Mega Ltd's opening negative amount is 2,000 so, in 2015, only 2,000 of the PE profits will be exempt from UK Corporation Tax. Profits of 2,000 will be subject to credit relief. Under CTA 2009 s18K(4), Mega will be able to specify the particular 2015 foreign branch profits that are being 'used up' by the opening negative amount. This will enable Mega to maximise its credit relief claim by, effectively, allocating the unused opening negative amount to the PE profits that have been subject to higher rates of tax in the source country.

It is possible for companies to elect to 'stream' particular, individual, branch results such that the results of that location remain within the credit system until the opening negative amount has been used up. Thus the exemption will apply earlier than would otherwise have been the case for the other branches. The loss amount streamed to the particular location concerned is the lower of (a) the opening negative amount for the streamed location itself and (b) the aggregate opening negative amount for all branches. Where the aggregate opening negative amount exceeds that attributable to the streamed territory, then the difference ('unstreamed loss') has to be offset against profits in unstreamed territories until exhausted, at which point the profits may benefit from exemption. The loss streaming election must be made at the same time as the election for exemption itself and is, similarly, irrevocable.

Further complexity in this area arises from anti-avoidance rules⁴⁴ designed to prevent companies from transferring the business of the loss-making PE to an affiliated company. Absent such rules, there would be no claw-back of tax relief previously given. Future profits in the PE of the affiliate will not be exempt until the loss/opening negative amount of the transferor company is exhausted; effectively, the opening negative amount is deemed to be assigned to the transferee company together with the business of the PE.

3(v) Funding.

In his Guardian article, George Monbiot remarked that whilst foreign branch earnings may be exempt, electing UK companies may continue to deduct the expenses of funding their foreign branches. In this respect it is correct that there is no limitation, as such, on UK companies' funding costs beyond the usual restrictions that require borrowers to be adequately capitalised

⁴⁴ s18O CTA 2009.

(internal debt) and limit deductions to a proportion of the worldwide group's borrowing costs⁴⁵.

As discussed above, however, the attribution of profits to exempt PEs requires external liabilities, including interest bearing debt, to be attributed. It follows that the costs of servicing the debt finance must also be attributed. In addition, intra-entity funding costs will be recognised under the attribution rules at s43 TIOPA (although not necessarily under the applicable double tax treaty if this is not based on the OECD 2010 Model). These measures will have the effect of reducing the tax base in the branch jurisdiction and increasing the tax base in the UK by reducing the exempt profits amount.

Given that one of the purposes of the new exemption was to align the treatment of overseas PEs with that of foreign direct investment via subsidiary companies, one must consider the treatment of the costs of funding those subsidiary companies. In this respect, even though income and gains of overseas subsidiaries are generally exempt in the UK under the distribution rules and substantial shareholding exemption⁴⁶, respectively, there is no restriction on funding costs beyond the general limitations described above.

It would, therefore, create asymmetry to deny relief for the interest of funding exempt foreign branches whilst allowing it for the purposes of funding subsidiaries. In the EU context, any such asymmetry could be challenged under the freedom of establishment rights guaranteed under Article 49 TFEU. Furthermore, one may observe that the requirement to reduce the UK exempt amount for branches to take into account debt finance of the legal entity does not apply to the exempt income of any subsidiaries that are wholly equity capitalised.

⁴⁵ Under the so-called 'worldwide debt cap' provisions at Part 7 TIOPA 2010, where the net debt of the UK member of a group of companies exceeds 75% of the group's external gross debt, deductions for interest payments may be restricted.

⁴⁶ The exemption of income is subject to the CFC rules.

4. Tax Competition.

‘....the Government believes that the corporate tax system can and should be an asset for the UK, improving the business environment and helping to attract multinational businesses and investment to the UK to support the recovery.’⁴⁷

In the following section I shall discuss the foreign branch exemption in the context of international tax competition. The CIN model/exemption facilitates tax competition to attract inward direct investment. Under CEN/credit, states will not necessarily attract investment by reducing their rates/bases. As discussed above, credit mechanisms set an effective minimum rate of tax for the capital exporter. Avery-Jones⁴⁸ and Kofler both identify a current global trend towards exemption. Kofler observes that 26 out of the 34 OECD Member countries adopt a territorial system whereby foreign profits are exempted. 3 Member countries moved towards exemption in 2009 alone (including the UK, as discussed above). The trend is attributed to increasing competitiveness of national tax systems. Among Mr. Monbiot’s objections to the exemption is that facilitating global tax competition will accelerate the so-called ‘race to the bottom’. This global degradation of the corporate tax base will, it is argued, result in an increase in public borrowing, reduction in public spending or regressive shift in tax burden to less mobile production factors such as labour and consumption, as discussed in Part 2. This will be considered in the UK context but, as described in Part 2, the exemption of foreign PE profits is immaterial in the context of UK public revenues.

The UK Government clearly regards tax competition between nation states as being, in principle, acceptable. Implicit in the question to be addressed by this paper is that some forms of tax competition are acceptable whilst others are not. Supranational bodies such as the OECD and the EU have addressed the question of tax competition and their findings and guidance as to acceptability of forms are essential in defining a framework of ‘acceptability’. The concept clearly remains subjective and certain commentators regard the supranational bodies as hypocritical (citing, for example, the EU Member States’ zealous protection of their independence regarding fiscal policies).

4 (i) Background.

Teather defines tax competition as ‘the use by governments of low effective tax rates to attract capital and business activity to their country’. The competition to attract portfolio investment may be distinguished from that to attract direct investment. States have competed to attract portfolio investment by exempting income from source country taxation via withholding. This has led to potential non-taxation when the investor fails to declare the income to the tax authorities in the residence state. This has been the focus of much attention by the OECD and, under threat of sanctions, has caused many tax havens to enter into Tax Information Exchange Agreements with other states to obviate the potential for tax evasion. We are, however, presently concerned with the competition to attract direct investment: production sites of enterprises, operating within a corporate or branch framework. Techniques employed by states in attracting such investment have typically included low tax rates, tax holidays and special base reductions (such as accelerated depreciation).

⁴⁷ Corporate Tax Reform: delivering a more competitive system; HM Treasury and HM Revenue & Customs, November 2010, para 1.2

⁴⁸ Avery-Jones 2011.

To the extent that the FA 2011 changes did, indeed, have the aim of making the UK's tax regime more competitive (see above for doubts as to that premise), the ambition would be to attract multinational companies (MNCs) operating via an international branch network where some or all of the branches are in low(er) tax jurisdictions. Tax competition is therefore relevant, albeit that the purpose was to attract foreign direct investment from companies actually looking to invest capital elsewhere. The overriding concept is to make the UK a fiscally attractive jurisdiction for holding companies; the foreign branch exemption simply seeks to make the relevant features available to inward investors whose outbound foreign direct investments take an unincorporated form.

It is beyond the scope of this paper to analyse the (de)merits of globalisation, per se. It is sufficient to remark that, as a result of technological advances, the relaxation of exchange controls and removal of other barriers to foreign trade that have taken place over the last 60 years, global GDP has increased exponentially. Teather, citing a 2003 OECD report by Maddison⁴⁹ shows that in the 25 years from 1973, per capita GDP increased by more than 50% in the USA, western Europe and Japan. In the rest of Asia, per capita GDP more than doubled in the period. (The statistics also reveal the shocking reality that, in the same period, the average economic output per person in Africa remained unchanged.)

The question dividing commentators is whether it is appropriate for countries to compete with each other to provide hosting services to companies (and individuals) in the same way as companies (and individuals) compete with each other to provide goods and services to customers.

The underlying rationale of tax competition is clear: the purpose is to attract foreign direct investment. As to its success in that regard, the empirical data suggest that it is, indeed, effective although there are dissenting opinions. De Mooij and Ederveen estimate that, on average, a 1% reduction in effective average tax rate ('EATR',⁵⁰) results in a 5.6% increase in foreign direct investment. Similarly, a 1% decrease in effective marginal tax rate ('EMTR',⁵¹) leads to 4% growth in the inward flow of foreign direct investment. On the other hand, in 2004, the consulting firm McKinsey⁵² conducted some research into the effectiveness of tax breaks on attracting investment into emerging economies. Their report concluded that, in many cases, the inward investment would have been made anyway based on criteria such as infrastructure, labour force, accessibility and the size of the domestic market in the country concerned. To that extent, tax holidays and other incentives are unnecessary and expensive concessions. Similarly, in a US study of state and local taxes, Lynch concluded that there were no grounds for supporting tax cuts and incentives to stimulate growth and employment.

As critics of tax competition have pointed out, if investment decisions of MNCs are driven primarily by local infrastructure and the availability of well-educated employees, then tax cuts must be counterproductive if they result in decreased spending on these aspects.

⁴⁹ A. Maddison, *The World Economy: A Millennial Perspective*, OECD.

⁵⁰ EATR is essentially derived from a calculation of the pre- and post-tax net present value of the return on an investment in each country. The investment is a notional composite of fixed assets, intellectual property and stock, funded by a mix of debt and equity capital (35:65). The relevant country-specific tax allowances and rates are then applied.

⁵¹ EMTR is a measurement of the increase in the cost of capital that is attributable to taxation.

⁵² Accessed at <http://mkqpreview1.qdweb.net/PDFDownload.aspx?ar=1386>

The Ruding Committee Report⁵³ from 1992 (which is discussed further below) concluded from an empirical study that location decisions of MNCs were, indeed, significantly influenced by tax considerations.

The dichotomy in views is easily explained by the difficulty in identifying factors of causation of the foreign direct investment into any given territory. In my opinion, however, the example of the Irish Financial Services Centre ('IFSC') is clearly indicative of the effectiveness of tax incentives on foreign direct investment. Established in Dublin 25 years ago, the IFSC enabled relevant businesses to enjoy a 10% rate and generous tax deductions. Although the rate subsequently increased, for reasons that will be discussed below, the effect on foreign direct investment into Ireland was enormous. The IFSC enabled Ireland to leverage one of its competitive advantages: a well educated workforce. The resulting employment opportunities helped to limit the historical problem of emigration of young people.

4 (ii) The UK position

Braithwaite⁵⁴ believes that international corporate tax competition began in 1984 when the UK cut its Corporation Tax rate from 52% to 35%. This provoked a response from the US which cut its rate from 46% to 34% in 1986. Corporate tax rates then continued to fall: between 1996 and 2003 the average rate in the 30 richest countries fell from 37.5% to 30%.

Despite being at the apparent vanguard, at least in terms of statutory rate, the UK's competitive position has weakened considerably in recent years. According to Bilicka et al, the UK corporate tax system lost competitiveness during the decade from 2001. As at 2011, according to their report, the UK ranked 9th out of the 19 G20 countries (excluding the European Union), based on EATR. (Using EMTR as the measure, the UK fared worse, being ranked 15th out of the 19.) In 2002, using the same methodology, the UK ranked 4th. It is interesting to note that this relative decline in competitiveness occurred despite a 0.6% reduction in the UK EATR over the period. This illustrates the relativity of tax competition: whilst the UK may do everything within its power to enhance its competitive position, other states may do more. This may lend support to the 'race to the bottom' argument. Additionally, however, these statistics illustrate the importance of tax base: based solely on the statutory rate of Corporation Tax, the UK ranked 7th in the G20 competitiveness table in 2011. This indicates that an uncompetitive tax base is the central issue and that successive cuts in the rate of Corporation Tax might not be effective as a competitive measure.

In terms of a regressive shift in the tax mix, there is no evidence to suggest that reductions in the statutory rate of UK Corporation Tax have lead to a material shift in the tax burden. The following tax contribution statistics published by HMRC on 20th July 2012⁵⁵ show that in the 10 years to 2011/2012, the proportional contribution of Corporation Tax to the government tax revenues remained fairly static at between 8 and 11%.

⁵³ Report of the Committee of Independent Experts on Company Taxation, EC Commission, March 1992.

⁵⁴ Braithwaite p20

⁵⁵ Accessed at http://www.hmrc.gov.uk/stats/tax_receipts/tax-nic-receipts-info-analysis.pdf. Last accessed 7th August 2012.

Contribution by tax to total HMRC receipts 2001 – 2012 (%)

Year to 5/4	IT,CGT, NIC	VAT	Corporation Tax	Hydrocarbon oils	Stamp taxes	Duties ⁵⁶	Other	Total revenue (£bn)
2002	54	19	10	7	2	4	3	321
2003	54	20	9	7	2	4	3	324
2004	55	20	8	7	2	4	3	344
2005	55	20	9	6	2	4	3	371
2006	55	18	11	6	3	4	4	398
2007	55	18	10	6	3	4	3	424
2008	56	18	10	6	3	4	3	451
2009	58	18	10	6	2	4	4	439
2010	58	17	9	6	2	4	3	409
2011	55	19	9	6	2	4	4	447
2012	54	21	9	6	2	4	4	467
Average	55	19	10	6	2	4	3	

4 (iii) The OECD and the EU: defining ‘harmful’ tax competition and countermeasures against it.

In 1991, the European Commission asked the former Dutch Finance Minister Onno Ruding to consider tax competition within (but also tax impediments to) the internal market. The Committee reported that there was no evidence to suggest that independent action by national governments is likely to provoke ‘unbridled general tax competition’ leading to erosion of the corporate tax revenues of Member States. There was, however, concern that Member States were introducing special tax schemes designed to attract internationally mobile business, particularly in the financial sector.

The UK’s 2011 move to elective exemption for foreign branches was ostensibly designed specifically to attract internationally mobile business and would be of particular relevance to financial sector companies. It could not, however, be described as a ‘special tax scheme’. This distinction is central to the differentiating characteristics of acceptable and unacceptable forms of tax competition within the normative framework established by the OECD and the EU.

Notwithstanding the apparent focus on ‘special schemes’, the Ruding Committee did recommend a minimum statutory corporation tax rate (30%) and also that common rules for a minimum tax base should be established ‘so as to limit excessive tax competition between Member States intended to attract mobile investment....’

Member States’ reluctance to cede fiscal sovereignty was always likely to be a barrier to such integration. In 1997, however, the Council did adopt a Code of Conduct for business taxation.⁵⁷ This Code which is effectively an agreed set of principles rather than a legally enforceable agreement ‘concerns those measures which affect or may affect in a significant

⁵⁶ = Excise duties levied on alcohol and tobacco.

⁵⁷ Resolution of the Council and the representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a Code of Conduct for Business Taxation.

way the location of business activity within the Community.’ As such, it establishes a model by which to assess whether tax competition initiatives are acceptable or not.

The Code applies to any tax measures (affecting rate or base) that provide for a significantly lower effective level of taxation than that generally applicable in the relevant Member State. Five disjunctive criteria are used to determine whether the tax measures reviewed are ‘harmful’. These are:

- the tax advantages apply only to non-residents of the state or only to transactions with non-residents;
- the tax advantages are not available in a purely domestic context or do not impact the national tax base;
- no real economic activity or substance is required to receive the tax benefits;
- profit determination differs from internationally accepted norms;
- the provisions are not transparent or are not operated in a transparent fashion.

Member States committed to refrain from introducing any new measures that would be considered harmful under any of the above criteria and also to amend any relevant laws and practices ‘as soon as possible taking into account the Council’s discussions following the review process.’ A working group was established (subsequently called the Primorolo group after its chair) in order to assess Member States’ relevant tax measures and, by 1999, the group had reported back that there were 203 potentially harmful regimes within the Member States and 86 in the various dependent territories such as the Channel Islands.

It seems clear that the UK’s foreign branch exemption would not be considered harmful within the EU’s definition: none of the five criteria is satisfied. In any event, many states adopt the exemption method to relieve the double taxation of permanent establishment income, albeit with some restrictions as to the nature of the business conducted and with anti-diversion rules (see further below). Thus the foreign branch exemption would appear to be perfectly acceptable from an EU Code standpoint.

In addition to the Code of Conduct, however, it is necessary to consider the State Aid rules. Article 3 TFEU awards the Union exclusive competence over ‘the establishing of the competition rules necessary for the functioning of the internal market.’⁵⁸ Under Article 107 TFEU, Member States are precluded from granting aid through state resources in any form whatsoever which distorts (or may distort) competition by favouring certain undertakings or the production of certain goods.

The potential application of the State Aid rules to business taxation was set out in a notice issued by the Commission on 11th November 1998⁵⁹. For a tax measure to be deemed to be illegal State aid, four (conjunctive) criteria must be satisfied. These are:

- the recipients benefit from a tax advantage in that they are relieved of a tax burden they would otherwise bear by means of a base reduction, tax credit or exemption or even by administrative measures that defer or cancel tax liabilities and
- the advantage must be granted by the State or through State resources and

⁵⁸ TFEU Article 3.1(b)

⁵⁹ EC Commission Notice of 11 November 1998 on the application of the State Aid rules to measures relating to direct business taxation (98/C384/03).

- the measure must affect competition and
- the measure must be selective⁶⁰ in terms of its application.

Where the Commission finds that Member State tax rules constitute illegal state aid that is not compatible with the internal market, 'it shall decide that the State concerned shall abolish or alter such aid within a period of time to be determined by the Commission. If the State concerned does not comply with this decision within the prescribed time, the Commission or any other interested State may....refer the matter to the Court of Justice of the European Union direct.'⁶¹

The IFSC regime discussed above was found by the Commission to be in breach of the State Aid rules and was withdrawn by the Irish government at the end of 2005. In order to continue to attract inward investment, the Irish government reduced the headline rate of corporation tax to 12.5% on all active business, thereby circumventing selectivity arguments.

The FA 2011 election could not constitute a breach of EU Law in this respect. There is no selectivity between taxpayers: all companies' foreign profits whether generated in subsidiaries or branches are or may be exempt, subject to CFC apportionment and the anti-diversion rules discussed below. Indeed, exempting dividends but not PE profits may potentially have caused a State Aid problem.

Aside from the EU, the OECD has been at the forefront of initiatives to tackle 'harmful tax competition'. In 1996, it was called upon to 'develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases'. When its report⁶² was published two years later, the OECD's Committee on Fiscal Affairs ('CFA') concluded that 'harmful tax competition', as defined, was caused by tax havens and 'harmful preferential tax regimes'. Harmful competition was said to

- distort financial and, indirectly, real investment flows;
- undermine the integrity and fairness of tax structures;
- discourage taxpayer compliance;
- re-shape the desired level and mix of taxes and public spending;
- cause undesired shifts of part of the tax burden to less mobile tax bases such as labour, property and consumption and
- increase administrative costs for taxpayers and tax authorities.

Harmful preferential tax regimes were defined by reference to factors such as no or low effective tax rates and a 'ring fencing' of regimes. (The latter concept is one whereby the benefits of the tax-advantageous system are not generally available to resident/domestic taxpayers.)

The 1998 report provoked some consternation amongst economists and businesses. The following year, the Business and Industry Advisory Committee to the OECD published 'A

⁶⁰ 'Selective' measures fall into three categories – aid to a particular business sector (e.g. Manufacturing, Financial Services etc); aid limited to certain territories or regions of Member States and 'horizontal' aid which is limited to particular functions of enterprises.

⁶¹ TFEU Article 108.2

⁶² OECD Report on Harmful Tax Competition – An Emerging Global Issue (1998)

Business View of Tax Competition’⁶³ which was highly critical of the CFA’s report and explained the benefits of tax competition as follows:

‘In the global economy, international tax competition among nations tends to keep the negative effects of taxation limited. [...]. Low tax rates tend to impose a discipline on the countries levying such taxes to make more efficient use of tax revenues in their spending decisions. The Report does convey an impression that the OECD is advocating a reversal of this trend, thus encouraging higher taxes.’

In 2001, consensus between the OECD committees was achieved and a paper by the respective chairmen was published. ‘Promoting Tax Competition’⁶⁴ essentially emphasised the importance of transparency and compliance but that there was no desire to harmonise tax structures or rates or set minimum levels of taxation. Since then, the Harmful Tax Competition Project has significantly focussed on transparency and, in particular, the concluding of Tax Information Exchange Agreements to inhibit tax evasion via the use of offshore accounts.

The 1998 Report did, however, recommend that states exempting foreign source income should restrict the scope of the exemption⁶⁵. The CFA’s recommendation was that income subject to a low level of tax in the source state as a result of the operation of a harmful tax regime there should not benefit from exemption in the residence/parent company state.

The UK rules (both for branch exemption and for attributing CFC profits) do consider the effective rate of tax in the source state but, as a result of challenges under European law discussed below, only as a part of the analysis. The critical test for exemption of profits in subsidiaries and branches is that those profits have not been artificially diverted from the UK.

4 (iv) Anti-diversion.

Under an exemption system, companies have an incentive to maximise profits in branches in low tax jurisdictions to minimise their effective tax rate. In order to protect the UK tax base from artificial diversions of profit to tax haven branches, FA 2011 introduced rules to disapply the exemption in certain circumstances. These provisions were temporary measures pending the introduction of a comprehensive new CFC regime in FA 2012 that is to be applied, *mutatis mutandis*, to foreign permanent establishments also.

In brief, the rules⁶⁶ do not allow for exemption if host-state tax on attributed profits is less than 75% of the UK tax that would be due. If the profits in the relevant territory (all branches) amount to less than £200,000 or the company passes the ‘motive’ test, then the exemption can still apply, notwithstanding the low tax in the host state.

The ‘motive’ test is passed, firstly, if a diversion of profits to reduce UK tax is not the main reason (or a main reason) for carrying on business through the permanent establishment. In this respect, a ‘safe harbour’ was introduced as a transitional provision⁶⁷. Essentially, this first aspect of the motive test would be deemed to be satisfied provided that the profits of the

⁶³ Accessed at <http://www.biac.org/statements/tax/htc.pdf>

⁶⁴ Accessed at <http://www.oecd.org/dataoecd/63/11/1915964.pdf>

⁶⁵ *ibid* Chapter 3 (II) para 3.

⁶⁶ s18G-H CTA 2009.

⁶⁷ Paras 31 and 32, Sch 13 FA 2011.

permanent establishment in the first exempt period did not exceed those of the immediately preceding period by more than 10%. Also there must be no major change in the foreign branch business and none of its assets can have belonged to a company within the CFC regime. Where the exempt business was carried on in an overseas company prior to the first exemption period, there are corresponding tests for the ‘safe harbour’ to apply.

The second requirement to pass the motive test is that any transactions reflected in the branch profit attribution may result in only a ‘minimal’ reduction in UK tax or, if the reduction is more than minimal, the transactions must not have been entered into for the (or a) main purpose of avoiding UK tax. A reduction in UK tax is determined by considering the position as it would have obtained if the transaction(s) had not been entered into. No hypothetical alternative transaction(s) are to be considered in making the comparison.

The multiplicity of situations wherein transactions may result in material reductions in UK tax places great emphasis on the rationale for entering into transactions. Thus subjectivity arises, including the relative importance of different factors in the decision-making process. HMRC guidance specifies that a transaction may fail the test if, notwithstanding a ‘genuine’ (i.e. non tax) purpose, ‘a reduction in UK tax was also one of the main purposes’.

The new CFC rules introduced in FA 2012 are, like the foreign branch exemption, apparently aimed at enhancing the UK’s competitive position (specifically as a holding company jurisdiction). The compatibility of the former regime⁶⁸ with European law had been successfully challenged by Cadbury Schweppes⁶⁹ and Vodafone⁷⁰. In the former, landmark, case the ECJ held that companies’ freedom of establishment⁷¹ was infringed by a requirement to include undistributed low-taxed profits of subsidiaries in other Member States within the domestic tax base. The freedom of establishment, however, did require genuine economic activities to be undertaken in the other Member State: if activities in the other state constituted ‘wholly artificial arrangements’, then a CFC regime could be compatible with EU Law.

The new CFC rules⁷² are lengthy and highly complex. In essence, profits are deemed to have been artificially diverted where (1) most of the profits are connected with ‘significant people functions’ performed in the UK and (2) there are no material non-tax reasons for the separation of people functions from offshore assets and (3) the arrangements between branch/subsidiary and head office/parent company would not have been entered into between third parties.

⁶⁸ Pt XVII Ch IV ICTA 1988.

⁶⁹ Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue C-196/04 [2006] ECR I-7995

⁷⁰ Vodafone 2 v The Commissioners of Her Majesty’s Revenue and Customs [2008] EWHC 1569 (Ch)

⁷¹ Articles 49 and 54 TFEU (ex Articles 43 and 48 TEC).

⁷² Part 9A TIOPA 2010.

5. Concluding remarks.

The twofold aims of this paper were to establish whether the elective foreign branch exemption was ‘acceptable’ tax competition and tax simplification and/or whether it was ‘the heist of the century’.

On the grounds that exemption is an internationally accepted standard for relieving double taxation one may, *prima facie*, conclude that the FA 2011 changes do fall within the bounds of acceptability. The changes do not appear to be ‘harmful’ within the definitions of the supranational bodies although there is no restriction on the scope of the exemption where a low effective rate of tax in the host state may itself be attributable to a harmful practice. There are, instead, rules restricting the scope of the exemption when profits are artificially diverted to exempt foreign branches. Contrivance is the key: if there is substantive investment into another state that has decided, in its national interest, to set effective tax rates at a particular level, the free movement of capital into that state should not be restricted by CEN considerations. This is so particularly when a mature economy such as the UK can no longer compete globally in capital-hungry manufacturing business but domestic companies do have capital to be deployed in generating economic return. The country is now predominately a service economy and its main ‘selling points’ are an internationally recognised legal system and well-trained professionals. It must be rational to attempt to attract businesses (such as holding companies) to leverage the economy’s strengths. As for tax relief for the costs of funding exempt foreign branches, as discussed in Part 3, a proper attribution (where possible under the relevant treaty pre-OECD 2010 Model) should preclude significant UK base erosion. In any event, the UK’s commitments to its EU partners rendered the exemption inevitable given the historical start-point of Corporation Tax exemption for domestic dividends. As discussed, we may trace the foreign branch exemption back to that position via exemption for dividends from overseas companies.

Economists disagree on the effect of the so-called race to the bottom and shifts in the tax burden to other production factors. The HMRC table at page 26 suggests that this has not occurred in the UK although the aggregation of IT, CGT and NIC is probably too broad to enable definitive conclusions. In addition, there is no consensus on whether higher levels of taxation at the corporate level actually push down labour costs (wages) given requirements for a minimum return on capital. If that is the case, higher corporate taxes may actually constitute a ‘heist’ on labour. On the other hand, as Professor Avery Jones says, ‘taxpayers under a credit system feel at a disadvantage when all the competitors are under an exemption system’. Amid the uncertainty, the fiscal prerogative of independent nation states to legislate in their own best interests must remain sacrosanct.

As for ‘simplification’, it seems clear that the election has no such claims: the complexities associated with losses, capital gains, capital allowances and profit attribution must surely negate any arguments that exemption is simpler than credit, albeit that certain features (e.g. profit attribution) are common to both systems.

Monbiot’s critique of the new exemption regime extended also to the composition of the committees ‘providing strategic oversight of the development of corporate tax policy’. Representatives of most major UK-headquartered MNCs are on such committees. It is not clear but presumably the objection is in respect of vested interests apparently determining government policy. HMRC, HM Treasury, the professional firms and others who provided

responses to the Consultation and the MPs who sit on the Public Bill Committee that discussed the Finance Bill would presumably find such an argument objectionable. Having HMRC and representatives from commerce/industry work on tax policy together must surely result in better, targeted legislation to implement the elected government's mandated proposals.

Finally, as to 'the heist of the century', the projected revenue impact calculations by HMRC simply fail to bear this out. Even if a reduction in corporate tax liabilities does indeed cause a regressive shift in the tax burden and, therefore, is a 'heist' (this is unproven on the UK data), a maximum impact of -£80m hardly qualifies as a robbery of significance in the scheme of HMRC's annual collections.

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